

Federal Reserve Bank of San Francisco

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China: Nation in Transition

China is a poor country, and the nation's present leadership continually reminds the populace of the need to modernize and catch up with the advanced industrial nations. China is also a country in transition, which is in the process of shifting from a rigid command economy towards one with more reliance on the market mechanism and enterprise autonomy. Given China's enormous geo-political importance as well as economic potential, we shall do well to obtain a realistic assessment of the nation's economy. Fortunately, under the new policy, a great deal of information on the Chinese economy is now published in the Chinese press. With the lifting of the veil, we can now discern more clearly the principal features of China's economic problems and the economic transformation that is taking place.

Background

China's problems, to a large extent, reflect the turmoil of the past half-century. By the time the Communist regime took over in 1949, the economy had been devastated by several decades of war and accelerating inflation. From 1950 to 1952, the Government succeeded in restoring order and stabilizing the economy. During the first Five-Year Plan (1953-58), it attempted to spur rapid economic growth while effecting a complete transformation from a private-enterprise to a socialist planned economy. During this period, private enterprise was wiped out in the industrial and commercial sectors, and agriculture was either nationalized or collectivized.

Periods of tumult and calamity followed—the Great Leap Forward of the late 1950s and (after four years of recovery) the Cultural Revolution of 1966-76—and these retarded the nation's economic progress by twenty years. After the dust settled, the nation emerged with outdated technology, low worker morale, and also a greatly swollen population. After a period of uncertainty

which followed Chairman Mao's death, the new leadership that then took power began to confront a host of difficult problems.

Economic planning

Many questions have arisen about the strategy and tactics of China's economic-planning process. Regarding basic strategy, China since the early 1950s has tried to achieve rapid economic growth through a high savings rate and investment concentrated in heavy industry. The result has been massive and prolonged neglect of agriculture, housing and consumer-goods industries. For example, agricultural per capita productivity has increased hardly at all in the past twenty years, and rural inhabitants earn only a fraction of what their urban counterparts earn. Urban housing is incredibly crowded, and there is general discontent over the low quality of consumer goods.

Faulty project planning has tended to undermine the development process, according to many newspaper reports and editorials. One recent case involved a gigantic irrigation project in Shanxi Province. This "Channeling West Water to the East" project had been hailed as a major achievement during the Cultural Revolution period, but it turned out to be a waste of resources, because it simply diverted previously used irrigation water from one side of a mountain range to the other. On a smaller scale, many press stories have reported examples of expensive imported equipment rusting away, unused or underused, because of shortages of raw materials or electrical power.

Excessive bureaucratic control, with inadequate coordination among enterprises, has also undermined the development process. Pricing and production decisions are made by central-government ministries or provincial and municipal bureaus, which are also responsible for the profits and losses of the industrial enterprises under their jurisdic-

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tions. Individual enterprises thus have no incentive to improve efficiency and output quality. A recent press story reported the problems of a steel plant and a coal mine which operate next to each other in Anhui Province. Yet, despite the best efforts of the plant managers, the coal mine had to sell its output to an enterprise in Jiangsu Province, and the steel plant had to buy its coal from Hubei Province—both on the instructions of their respective industry bureaus, which could not get together to adjust the orders, even though they were located in the same government-office building.

Work incentives

Lack of incentives has also plagued the economy's performance. Throughout China, the central authorities set wage and salary scales, for everyone from top government officials and university professors to menial laborers. Moreover, wages and salaries have been practically frozen for decades, aside from a small adjustment in 1979. Promotions are relatively rare. Most workers receive the same wage or salary regardless of performance, and worker morale suffers as a consequence.

Unemployment, overt or disguised, is another feature of the labor market. Until recently, there has been little public admission of unemployment in China. But, under the new policy of economic pragmatism, the subject is no longer taboo. Indeed, a national conference on employment this August emphasized the need for creating jobs for young workers. Moreover, disguised unemployment is widespread. Some even defend this practice as an equitable social policy, on the ground that it is better for five people to do the work of two, so that all five can eat, whereas otherwise only two could eat and three would starve. Equity considerations aside, low labor productivity is the obvious result of this employment practice.

Productivity problems have been aggravated by poor management performance, as a result of the lack of trained personnel or the

poor quality of the personnel occupying management positions. The lack of trained managers came about largely because of the disruption of the nation's education system during the Cultural Revolution, which cost China a whole generation of managerial and technical personnel, and which led to the appointment of many managers on grounds of ideological purity rather than technical expertise. Much time and effort will be required to train a new generation of managers, and to replace the incompetents appointed during the Cultural Revolution.

Pricing

The pricing problem, as in all centrally-planned economies, underlies most of China's other problems. Chinese economic literature frequently refers to the "scissor gap" problem, having to do with the appropriate ratio of farm input and output prices. The problem stems from a government policy of arbitrarily maintaining high industrial prices at the expense of farm prices, resulting in a very high effective rate of farm-sector taxation and a low rate of farm productivity. The coal industry has also suffered from deliberate underpricing by the authorities. On the other hand, the electric-machinery industry suffers from overproduction and low quality of output, as a result of overpricing and protective policies instituted by provincial authorities against imports from abroad and even from other parts of China.

The pricing problem also afflicts the foreign-trade sector. The central authorities arbitrarily set the foreign-exchange rate of the renminbi, with little relevance to domestic and foreign price trends. Foreign-trade authorities purchase domestic goods for export and sell imported goods, both at domestic prices. Since domestic prices tend to be higher than world prices converted at the current exchange rate, the authorities tend to lose money on exports while making money on imports. The overvaluation of the national currency provides no market incentive to export but provides a strong attraction to import, with the trade kept roughly in balance

only through administrative controls by the economic-planning authorities.

Nation in transition

In the past several years, China's leaders have moved energetically and pragmatically to overcome this long catalog of problems. The new policy includes such elements as scaling down investment projects, re-setting of investment priorities, and increased reliance on the market mechanism. The overly ambitious Ten-Year Plan (1976-85) announced in March 1978 was shelved the following year, for fear that investment beyond the nation's savings capacity would lead to inflation and heavy reliance on foreign lenders, as occurred in Poland and other Eastern European countries. Instead, the decision was to retrench, re-adjust, and consolidate. Existing investment projects will be allowed to continue, but new large projects will require specific authorization from the central authorities.

Besides scaling down the development plan, the authorities have begun to deemphasize heavy industry—in favor of agriculture, textiles and other consumer industries, housing, transportation and energy production. The shift was designed to redress the balance between investment and consumption, in order to raise living standards and provide greater work incentives for China's labor force. The new investment policy also was designed to favor labor-intensive projects and those with shorter gestation periods and more potential for generating export revenue.

The market mechanism meanwhile has come into greater use throughout the economy. In agriculture, the authorities have reduced the scope of state purchases of farm products, and have allowed households small family plots to grow products for their own consumption and for free-market sales. The authorities have generally encouraged agricultural communes and collectives to make their own production plans and to withhold larger portions of their profits, either for reinvestment or for distribution to their members. They have also encouraged these

entities to develop cottage industries, either by themselves or in joint ventures with provincial or municipal enterprises elsewhere.

Individual enterprises in industry, aside from receiving greater autonomy, are now dealing with industry bureaus on the basis of negotiated contracts rather than imposed quotas. More managers are receiving bonuses if contract goals are exceeded, although the bonuses generally are rather small—roughly one-third of monthly salaries. Price flexibility is becoming more common—for example, in the electric-machinery industry, where prices have been reduced to reflect a general condition of excess supply. More difficult decisions lie ahead, however, as pressures build to boost prices on products and services in short supply, such as coal, minerals, vegetable oils and other farm products, housing, and public transportation.

Prospects

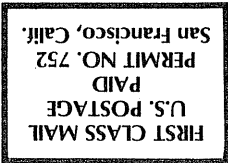
Altogether, China still has many difficult problems to overcome as it moves toward its goal of development through liberalization. The general direction has been set at the top level, but a great deal of uncertainty surrounds the implementation of basic policy. Changes are being made cautiously and slowly. Yet slowly but steadily, rigid planning is giving way to greater enterprise autonomy, political slogans to economic incentives, and xenophobia to greater openness to outside contacts. A great experiment is in progress to determine what the market mechanism can do to improve the performance of a socialist economy. On the outcome of that experiment depend not only the livelihood of one-quarter of mankind, but also the peace and prosperity of a vitally important region of the world.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 10/8/80	Change from 10/1/80	Change from year ago	
			Dollar	Percent
Loans (gross, adjusted) and investments*	141,271	- 125	5,995	4.4
Loans (gross, adjusted) — total#	119,340	- 122	7,367	6.6
Commercial and industrial	34,770	- 404	3,009	9.5
Real estate	48,334	203	6,964	16.8
Loans to individuals	23,787	- 46	344	1.5
Securities loans	985	44	- 1,220	- 55.3
U.S. Treasury securities*	6,482	- 44	- 1,158	- 15.2
Other securities*	15,449	41	- 214	- 1.4
Demand deposits — total#	46,101	- 827	180	0.4
Demand deposits — adjusted	33,984	228	1,250	3.8
Savings deposits — total	29,838	- 96	- 556	- 1.8
Time deposits — total#	64,727	579	9,752	17.7
Individuals, part. & corp.	56,115	498	9,533	20.5
(Large negotiable CD's)	24,462	- 397	4,009	19.6
Weekly Averages of Daily Figures	Week ended 10/8/80	Week ended 10/1/80	Comparable year-ago period	
Member Bank Reserve Position				
Excess Reserves (+)/Deficiency (-)	- 38	- 3		53
Borrowings	38	188		96
Net free reserves (+)/Net borrowed(-)	- 76	- 192		43

* Excludes trading account securities.
Includes items not shown separately.
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